

ISLAMIC FINANCE

*Global Legal Issues
and Challenges*



ISLAMIC FINANCIAL SERVICES BOARD





Islamic Finance: Surveys on Global Legal Issues and Challenges



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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars, and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit www.ifsb.org



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Preface

In the name of Allah, the Most Gracious, the Most Merciful.

As the body mandated by the regulatory and supervisory agencies that have a vested interest in ensuring the soundness and stability of the industry, the Islamic Financial Services Board (IFSB) has primarily focused its work on developing international prudential standards by introducing new or adapting existing international standards which are consistent with the *Shari'ah* rules and principles. We acknowledge that a comprehensive and effective legal framework is a key component of a sound and stable Islamic financial system. In this respect, our *Guiding Principles of Risk Management for Institutions offering Islamic Financial Services* (IIFS), published in December 2005, has stated the need for IIFS to establish an appropriate policy and infrastructure in order to manage legal risk and *Shari'ah* compliance risk, which are considered to be part of the operational risks of IIFS.

Hence, the IFSB organises a series of annual seminars on legal issues in the Islamic financial services industry (IFSI), which we believe will form the impetus for continuing to promote awareness and build consensus on how legal issues in the IFSI should be understood and tackled. The first seminar, held in Kuwait in 2005, discussed, *inter alia*, the basic form of Islamic financial contracts, as well as product structures, from home financing to corporate and project financing; while the second seminar, held in London in 2006, adopted securitisation and insolvency as the two key legal areas for discussion.

This book is published in conjunction with the third in this series of seminars, held in Kuala Lumpur in March 2007. It is compiled from five original surveys commissioned by the IFSB of several highly reputable international firms. The surveys addressed (i) the effectiveness of the legal framework, (ii) insolvency laws, (iii) securitisation laws, (iv) trust laws, and (v) roles of the *Shari'ah* boards in relation to the IFSI. We believe this work is the first large-scale stock-taking initiative ever carried out, in terms of analysing the existing legal framework and examining the key legal issues faced by the IFSI across several jurisdictions, especially in the light of the more globalised environment the industry is entering.

Chapter One, prepared by Dato' Dr. Nik Norzrul Thani and Dr. Aida Othman, presents an overview of the importance and significance of an effective legal framework for Islamic financial services. The authors analyse the existing legal frameworks as applied to the Islamic financial services industry in more than 30 jurisdictions, in order to determine whether they are capable of meeting three basic tests of an effective legal framework.

The authors argue that a legal framework for Islamic finance can be considered effective if it appropriately and adequately (i) provides an enabling environment to accommodate and facilitate the development of Islamic finance; (ii) preserves the enforceability of Islamic finance contracts; and (iii) ensures an effective legal process for the settlement of disputes. The authors' efforts in identifying the various sets of Islamic finance laws and regulations in diverse types of jurisdictions around the world, as well as classifying them into several models, will provide an important reference tool for anyone interested in studying legal frameworks, especially those regulatory and supervisory authorities wishing to evaluate the options they might have in setting out a conducive legal environment for Islamic finance in their jurisdictions.

Chapter Two, prepared by Hamid Yunis and Rabel Akhund, focuses on the issues of insolvency law as a core framework in determining the health status of IIFS, as well as issuers of Islamic securities, widely known as *sukuk*. The authors highlight, *inter alia*, the challenges of defining what legally constitutes "default" and the state of being "insolvent" in Islamic financial contracts, bearing in mind that some Islamic finance transactions are based on partnership and profit-sharing and thus do not guarantee the payment of any returns to the investors or even the

repayment of capital. Certainly this would affect a broad range of aspects, including the creditworthiness and rating of the relevant institutions, and of course, ultimately, the consumer's confidence. The authors also share their findings from a survey conducted among a number of law firms and other professionals on insolvency issues surrounding Islamic finance, covering major jurisdictions such as Bahrain, Kuwait, Pakistan, Saudi Arabia and the United Arab Emirates.

The next two chapters have been largely based on and adapted from a special report prepared by Michael J.T. McMillen as part of a programme undertaken by the IFSB under joint technical grants from the Islamic Development Bank and the Asian Development Bank to identify and analyse the relevant securitisation and trust law issues, considered vital for further development of Islamic finance, especially considering the recent exponential growth of the *sukūk* market.

In Chapter Three, McMillen takes a closer look at the legal issues surrounding securitisation based on *Sharī'ah* rules and principles, in order to determine what may be needed to ensure that any potential legal hazard is properly identified and addressed. To a large extent, *sukūk* issuance easily exemplifies the most diverse dimensions of legal risks attached to Islamic finance, as many of these *sukūk* are also subscribed to by international investors beyond the borders of their issuers, and are sometimes listed on foreign securities exchanges. In other words, *sukūk* issuance is an interesting case study of how international Islamic finance deals are done, considering the multiple jurisdictions of law and regulatory processes often needed to be overcome in order to ensure a successful issue.

In Chapter Four, McMillen collaborates with Sheikh Yusuf Talal DeLorenzo to discuss the interface between modern trust laws and *Sharī'ah* principles relating to trust, which is of particular importance for protecting the interests of investors in securitisation deals, although they may also be relevant to other *Sharī'ah*-compliant fund management contracts. While specific trust laws may not necessarily exist in all jurisdictions where *sukūk* issuances have been originated, some form of contractual safeguards would be needed. The chapter evaluates the solutions that can be considered by market players, as well as by regulatory and supervisory authorities, in adapting to the development, or rather the lack of it, in this area of law in their respective jurisdictions.

Chapter Five deliberates on the findings by Dr. Syed Musa Alhabshi and Dr. Mohd Daud Bakar from a survey relating to *Sharī'ah* boards and *Sharī'ah* governance involving 69 respondent IIFS from 11 countries. This survey seems to be the most authoritative study ever done in this area, and should provide a sound basis for further strengthening the *Sharī'ah* compliance framework for IIFS in particular, and for the industry as a whole.

Chapter Six provides some additional perspectives on issues that have been covered in the earlier chapters, before concluding that there is a strong justification for the efforts to intensify the legal scholarship in this area. The legal and *Sharī'ah* issues are foreseen to continue posing a major challenge for the regulators and market players alike as the industry pursues its exponential growth in a highly competitive and globalised environment, and the urgency for an effective framework will be more pressing than ever.

Madzlan Mohamad Hussain, Senior Project Manager at the IFSB, has done an excellent job in reviewing the various chapters and providing useful comments to the authors, while Siham Ismail, Senior Executive, assisted in the proof-reading and printing process.

The IFSB is thankful to Kuwait Finance House Malaysia Berhad for kindly sponsoring the publication of this book.

Professor Rifaat Ahmed Abdel Karim, Ph.D
Secretary-General
Islamic Financial Services Board

About the Contributors

Rifaat Ahmed Abdel Karim is the Secretary-General of the Islamic Financial Services Board (IFSB), a post he has held since the IFSB started operations in 2003. Prior to his current post, he was the Secretary-General of the Accounting and Auditing Organisation for Islamic Financial Institutions. He is a member of both the Standards Advisory Council of the international Accounting Standards Board, now serving his second three-year term, and the Consultative Advisory Group of the International Auditing and Assurance Standards Board. Rifaat has been Visiting Professor at the University of Surrey (UK) since 1996, and is an Honorary Professor at Monash University in Australia. He is the co-author of *Islamic Finance: The Regulatory Challenge* (published by John Wiley & Sons), *Islamic Finance: Innovation & Growth* (published by Euromoney) and *Business and Accounting Ethics in Islam* (published by Mansell). He is a recipient of the Euromoney Outstanding Contribution to the Development of Islamic Finance Award, and other distinguished awards.

Rabel Akhund is a senior associate in the Finance & Projects Department at Taylor Wessing, UK and had joined the firm from Baker & McKenzie. He specialises in advising private equity clients and institutional lenders on cross-border leverage finance and Islamic finance transactions. Between 2005 and 2007 alone, Rabel had worked on and completed cross-border leverage finance transactions in excess of Euros 5 billion. He also advised on Pakistan's first-ever institutional microfinance *murābahah* transaction (believed to be the largest at the time), and regularly advises on commodity *murābahah* and *ijārah* lease transactions for leading UK clearing banks and Middle Eastern banks. Rabel is also a regular contributor of academic articles on Islamic finance.

Rabel obtained his LL.B in 1997 and his LL.M. in 1998 from University College London.

Dr. Syed Musa Alhabshi is a Principal Consultant at Amanie Business Solutions Sdn Bhd, Kuala Lumpur. Until recently, he was Dean – Faculty of Business Administration, University of Tun Abdul Razak (UNITAR) and is involved in the Islamic banking industry as a trainer, consultant and researcher in the field of Islamic accounting, auditing and governance. He is actively involved in setting international accounting and prudential standards for the financial industry, among others, as a member of the Bahrain-based Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) Accounting and Auditing Standards Board, a working group member of Malaysia Accounting Standards Board (MASB) Accounting Standards, and one of the international consultants to the IFSB for its standard on Transparency and Market Discipline. As a trainer, he has been appointed by the Islamic Development Bank (IDB) to facilitate workshops on the Islamic Certified Analyst Programme held by Bank Muamalat Indonesia. He has provided consultancy to various financial institutions, as well as being appointed as an Investment Committee member of a unit trust fund.

Syed Musa began his career as a National Service Police Inspector in Singapore, after which he was employed as an audit assistant at Coopers & Lybrand, Singapore. He then served as an Assistant Lecturer and Assistant Professor in the Kuliyyah of Economics and Management Sciences, International Islamic University Malaysia (IIUM) before joining UNITAR. He has held several other academic positions, including Head of Accounting Department and Head of Post Graduate Diploma in Islamic Banking and Finance. He has taught both undergraduate and graduate students, supervised doctoral theses, and designed programmes and courses related to the areas of accounting, finance and Islamic banking. His research interests and publications include accounting, auditing, governance, *zakat*, performance measurement, finance and banking from Islamic perspectives.

Syed Musa gained a Diploma in Business Studies (Financial) from Ngee Ann Polytechnic, Singapore and a Bachelor of Business Administration with First Class Honours from the IUM, winning the Best Overall Student Award awarded by Bank Islam Malaysia Berhad. He also holds a Masters of Science in Finance and a Doctorate in Business Administration (Accounting and Finance) from University of Strathclyde, United Kingdom.

Dr. Mohd Daud Bakar is currently the President/CEO of the International Institute of Islamic Finance (IIIF), Inc. (BVI) and Amanie Business Solutions Sdn Bhd (Kuala Lumpur). He was formerly the Deputy Rector (Student Affairs and Development) and an Associate Professor at IUM. He has been a member of numerous *Shari'ah* boards, both local and abroad, including the *Shari'ah* Advisory Councils of Bank Negara Malaysia, Securities Commission of Malaysia, Labuan Offshore Financial Supervisory Authority and Labuan Financial Exchange, AAOIFI and International Islamic Financial Market (IIFM) in Bahrain, Oasis Asset Management, Cape Town, South Africa, Dow Jones Islamic Market Index, New York, Guidance Financial, USA, Unicorn Investment Bank and BNP Paribas, Bahrain, and in other financial institutions. He has been involved in advising Islamic funds and Islamic *sukuk*, both local and globally. He is a licensed *Shari'ah* adviser for Islamic securities in Malaysia.

Mohd Daud has published more than 50 articles in various academic journals and presented more than 120 papers at conferences both locally and abroad. He received his first degree in *Shari'ah* from the University of Kuwait in 1988, and a Ph.D from the University of St. Andrews, United Kingdom in 1993. In 2002, he completed his Bachelor of Jurisprudence (External) at the University of Malaya.

Sheikh Yusuf Talal DeLorenzo is a well-known *Shari'ah* adviser and Islamic scholar whose career spans more than 25 years. Based in the Washington, DC area, he serves as a *Shari'ah* adviser for nearly 20 financial entities, including index providers, institutional investors, mutual funds, real estate funds, private equity funds, home finance providers and banks.

Yusuf is the author of *A Compendium of Legal Opinions on the Operations of Islamic Banks*, the first-ever English/Arabic reference on the legal rulings issued by *Shari'ah* boards. The three-volume publication has become a standard reference for Islamic financial institutions. Yusuf has written numerous articles and research papers on topics related to Islamic finance. His work has appeared in the *ABANA Review* (the newsletter of the Arab Bankers Association of North America), and as chapters in *Islamic Asset Management, Islamic Retail Finance and Islamic Finance: Innovation & Growth* (all published by Euromoney). His entries on the terminology of Islamic finance appear in *The Oxford Dictionary of Islam*. Yusuf has authored several works on Islamic law, including introductions to popular works on Islamic finance; and he presents his work at financial and legal forums worldwide. He has translated into English several important Islamic works, including Imam Bukhari's *Book of Muslim Morals and Manners*, Abu Hamid al-Ghazali's *Kitab al-Halal wa'l-Haram*, and Shaykh Muhammad al-Ghazali's *Remembrance and Prayer*.

Michael J.T. McMillen is a partner in the international law firm of Fulbright & Jaworski L.L.P. and teaches Islamic finance at the University of Pennsylvania Law School and the Wharton School of Business. He also teaches Islamic finance programmes at the Middle East Partnership Initiative administered by the University of Pennsylvania Law School and the Wharton Executive Education Department, as well as at other institutes and schools in the United States, Europe and the Middle East. He is currently the Chair of the Islamic Law Forum, a division of the American Bar Association International Law Section.

Michael has worked in the Islamic finance field since 1996 and in the field of project finance since 1983. He has twice received the Euromoney Award as Best Legal Advisor in Islamic Finance (most recently for 2006/2007 and the first such award in 2004) and is the 2007 recipient of the

Sheikh Mohammed bin Rashid al-Maktoum Award for Best Legal Advisor in Islamic Finance: Americas. He has authored more than 50 articles on Islamic finance, including in leading law journals such as the *University of Chicago Journal of International Law*, the *Capital Markets Journal* published by Oxford University, the *Fordham International Law Journal* and the *Wisconsin Journal of International Law*. He also speaks extensively on different topics in the fields of Islamic finance and project finance.

Madzlan Mohamad Hussain has been with the IFSB since April 2004, when he first joined as a Project Manager; he was later promoted to Senior Project Manager. He is responsible for overseeing the development of IFSB prudential standards on corporate governance practices for all segments of Islamic financial services, including banking, capital markets and insurance. Prior to joining the IFSB, Madzlan was a senior associate at one of the premier law firms in Kuala Lumpur, where he specialised in capital markets practices, corporate and debt restructurings, as well as Islamic finance.

Madzlan graduated with a Bachelor of Laws (Hons) from IIUM in 1998 and obtained his Master of Science in Islamic Economics, Banking and Finance from Loughborough University, United Kingdom in 2002. He attended Summer School at Sophia University in Tokyo, Japan in 1997 and is a Chevening Visiting Fellow at the Oxford Centre for Islamic Studies, United Kingdom for 2007/2008.

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Dato' Dr. Nik Norzrul Thani Nik Hassan Thani is a senior partner and chairman of Zaid Ibrahim & Co., Malaysia's largest law firm. He advises clients on a wide range of legal matters, including Islamic finance, banking, offshore finance, debt restructuring, and international, corporate and commercial law. A renowned lawyer and prolific writer on corporate and financial law, including Islamic banking, Nik authored *Legal Aspects of the Malaysian Financial System* and co-authored *Law and Practice of Islamic Banking & Finance*, both books published by Sweet & Maxwell Asia. He sits on the Board of Directors of Lembaga Tabung Haji (Malaysia Pilgrimage Fund), as well as on several government committees on Islamic banking and finance. Prior to practising, Nik was Deputy Dean of IIUM's Law Faculty and former Vice President of the Commonwealth Legal Education Association. He was a Fulbright Visiting Scholar for Harvard's Islamic Studies Programme in 1996/1997 and Chevening Visiting Fellow to the Oxford Centre for Islamic Studies in 2004/2005.

Nik obtained his Ph.D in Law from the School of Oriental and African Studies, University of London and a Masters of Law from Queen Mary and Westfield College, University of London. He read law at the University of Buckingham, United Kingdom. He also holds a Post Graduate Diploma in *Shari'ah* Law and Practice (with Distinction) from IIUM. He is a barrister of Lincoln's Inn and was called to the Bar of England and Wales in 1985 and to the Malaysian Bar in 1986.

Hamid Yunis is a partner in the finance and projects department of Taylor Wessing, based in their City of London office. Having initially trained as a corporate finance lawyer, Hamid has been involved since the mid-1990s in the successful structuring and negotiation of a number of major

projects and project finance transactions, both in a domestic UK context and internationally, and in a diverse range of industries and sectors. Hamid leads the Middle Eastern Group and the Healthcare Infrastructure & Services Group in Taylor Wessing.

Hamid also leads the Islamic Finance Group of Taylor Wessing and is both a recognised industry specialist and adviser to a number of leading institutions in this sector. He has been instrumental in the development and use of innovative legal and commercial structures in some of the largest *Shari'ah*-compliant transactions to have closed. The Islamic Finance Group includes lawyers from a number of different disciplines across Taylor Wessing, including Finance, Projects, Corporate, Tax and Commercial Property.

Hamid was named by *Legal Business* as a leading expert in his field and is a regular industry speaker and contributor. He was also listed in "Legal Experts 2003" for Corporate, Mergers & Acquisition. Prior to joining Taylor Wessing, Hamid was a partner at Andersen Legal, where he headed the Major Projects Group.

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- the learned Professor William Blair, QC, Chairman of the International Monetary Law Committee, International Law Association (MOCOMILA), for his keynote address at the seminar;
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- all IFSB members for their participation in the respective surveys and unwavering support of the IFSB's initiatives.

Opening Remark

H.E. Tan Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

Chairperson, Islamic Financial Services Board (2007)

Professor William Blair QC, Chairman of the International Monetary Law Committee of the International Law Association (MOCOMILA);

Professor Rifaat Ahmed Abdel Karim, Secretary-General, IFSB;

Distinguished guests;

Ladies and gentlemen.

I would like to join Professor Rifaat in welcoming you to this 3rd IFSB Seminar on Legal Issues. I would also like to take this opportunity to extend a special welcome to the many of you who have travelled long distances to join us for this important event.

A strong legal and *Shari'ah* framework as a pillar to Islamic finance

The need to continually strengthen the legal framework for the financial services industry is imperative given the powerful forces of change continually transforming the functioning of the global economy and the international financial system. A legal framework which is aligned with market developments lends certainty and predictability to financial transactions and innovative products and instills public confidence in the financial system.

The legal and *Shari'ah* framework is a vital pillar in the sustainable development of Islamic finance. It provides the legislative framework that unambiguously defines the conduct of Islamic financial institutions. It also gives due protection to the consumers of Islamic finance, ensures the enforceability of Islamic financial contracts and provides an effective mechanism for legal redress.

The legal framework for Islamic finance also needs to address any specific elements that could result in a comparative disadvantage to the industry. More specifically, in a world in which finance has long been defined by conventional practices and laws, the features that are unique to the requirements of Islamic finance need to be taken into account to ensure neutrality of treatment.

In Malaysia, the rapid evolution of Islamic finance has been supported by the development of a comprehensive legal infrastructure. A series of legislation since 1983 has provided the foundation for a regulatory regime for Islamic banks, *takaful* operators, the *Shari'ah* Council for Islamic finance, Islamic finance windows in conventional banks, and the various forms of bond and money market instruments. In addition, the corporate, securities and insolvency laws and guidelines are compatible with the *Shari'ah*. These legislation have been reinforced by the establishment of a dedicated High Court bench to provide a comprehensive adjudicative system to deal with disputes involving Islamic finance. In addition, the new Islamic Finance Arbitration Rules of the Kuala Lumpur Regional Centre for Arbitration provides a customised mechanism for the resolution of disputes in the Islamic financial services sector.

The development of an efficient and vibrant Islamic financial market

Equally important to the development of Islamic finance is not only the financial intermediaries but also the Islamic financial markets. The demand for Islamic financial products and instruments is expanding at increasingly significant rates in predominantly Muslim countries in the Middle East and Asia, as well as in the non-Muslim economies in the West. The rapid growth of the Islamic financial markets has seen the development of a wide range of products, including money, debt and capital market instruments. Such markets are important for the effective management of investment portfolios and for the diversification of risks.

Today, the global demand for Islamic capital market products is served by the existence of the Dow Jones Islamic Index whose market capitalisation now exceeds US\$10 trillion. About 350 *Shari'ah*-compliant funds have already been established across the globe.

In Malaysia, the *sukuk* market has been a leading segment of growth in the domestic bond market accounting for half of our domestic bond market and two-thirds of the total global outstanding *sukuk*. A wide range of new Islamic financial instruments has been developed, including the Bank Negara Malaysia *Sukuk Ijārah*, Bank Negara Malaysia Monetary Notes, the Islamic residential mortgage-backed securities and, most recently, the Commodity *Murabahah* Programme for managing short-term liquidity in the inter-bank money market.

While Islamic finance practitioners and scholars continue to draw from the source of *fiqh muamalat* to create new and innovative instruments, the legal framework needs to be further strengthened to ensure continued acceptance and utility of the financial instruments. In Malaysia, the progress in this area has been facilitated by the common law which forms the foundation of the legal system. More specifically, the concept of "trust" under the common law has facilitated the issuance of Islamic securities such as *sukuk* and Islamic Real Estate Investment Trust (REIT). Since "trust" as an inherent notion embedded in the common law system is not generally found in the jurisprudence of civil law, some civil law countries have enacted specific legislation to provide for the introduction of trust so as to align their legal systems with the requirements of Islamic finance.

The challenges brought by the integration of Islamic finance with the international financial system

While legal issues within a domestic financial system can be resolved by the home regulators and *Shari'ah* authorities, the integration of Islamic finance with the international financial system brings with it many challenges. There is a need for mutual recognition of financial standards and products across jurisdictions. The progressive harmonisation of *Shari'ah*, in this respect, needs to be viewed as a driver towards greater international financial integration.

Such a convergence and harmonisation can only happen with greater engagement among the regulators, practitioners and scholars in Islamic finance in the international community. The Annual International *Shari'ah* Scholars' Dialogue that has been taking place since 2005 is aimed at achieving this objective. This Dialogue has served to promote interactions between *Shari'ah* scholars from around the world contributing towards greater understanding and international convergence.

In Malaysia, the efforts to enhance the international dimension of our Islamic financial system have been intensified in the more recent period to facilitate greater international trade and cross-border investment flows. The new initiatives that have been announced allow the establishment of new International Islamic financial institutions that will be permitted to offer the full range of Islamic financial services to residents and non-residents in international currencies. These initiatives also aim to serve as a catalyst for the development of the domestic financial markets as well as the development of talent and knowledge in Islamic finance. Collaboration with other

emerging regional centres in Islamic finance will be an important part of this process that will contribute towards greater international financial integration.

The establishment of the Islamic Financial Services Board in 2002 represents a major structural enhancement in building the international financial architecture for Islamic finance. The achievements thus far by the Islamic Financial Services Board in developing the prudential standards that can be universally applied have been very encouraging. The efforts represent a testimony to the collective capacity for greater international collaboration which has contributed towards strengthening the fabric of Islamic finance.

While the legal framework and rules are constantly being reviewed to ensure that they remain relevant for the new areas of financial activity, it should not only be undertaken for the domestic Islamic financial system but also in the context of the international financial system.

Conclusion

In closing, I would like to take this opportunity to congratulate the Islamic Financial Services Board for commissioning the “Surveys on Legal and *Shari’ah* Issues in the Islamic Financial Services Industry”. The survey findings represent an important contribution towards augmenting the literature on the existing legal and *Shari’ah* framework across different jurisdictions. It serves as a useful source of reference for countries that are interested in establishing a legal and *Shari’ah* framework for their Islamic financial system. Deliberation on the survey results and the exchange of views and experiences among lawyers, *Shari’ah* scholars and Islamic finance practitioners will be important in contributing to increasing the efficiency in Islamic finance and facilitating its robustness as an integral component in the global financial system.

Thank you.

Keynote Address

Professor William Blair, QC
Chairman of the International Monetary Law Committee
of the International Law Association (MOCOMILA)

Your Excellency Dr. Zeti Akhtar Aziz, Governor, Bank Negara Malaysia;

Professor Rifaat Ahmed Abdel Karim, Secretary-General, IFSB;

Council members of the IFSB;

Distinguished ladies and gentlemen.

It is a great privilege to be present at this part of the inaugural Global Islamic Finance Forum.* It is also, Secretary-General, a great honour to share the platform with the Governor of Bank Negara Malaysia, whose contribution has been so important in this and so many other fields, and of course yourself, and before an audience of so many distinguished delegates. I thank you and the IFSB for the kind invitation to give this keynote address this morning.

I also thank my colleagues at the Bar Council of Malaysia for their support of this seminar.

Secretary-General, this is the second time that I have had the good fortune to have been invited by the IFSB to speak at its Seminar on Legal Issues in the Islamic financial services industry.

In Kuwait in 2005, we were all aware that this was work in progress. And it still is. I sometimes say to people that Islamic finance is like the booming cities of the Gulf – or indeed this booming city of Kuala Lumpur – surrounded by cranes and architects. There is a real sense of buzz. But over the last two years, I think we can say that the study of *legal* issues in contemporary Islamic finance has begun to acquire a sense of direction.

In this we are greatly indebted to the scholars of the *Shari'ah*, and I thank those present for all they have achieved. If I may quote the Governor at the launching of the International Centre for Education in Islamic Finance on 23 March 2006, "Sound policies and practices premised on *Shari'ah* principles will evolve the Islamic financial system into a financial system that is distinctively ethical and which promotes economic justice." And that, of course, is the heart of the matter, and why we can respectfully share in the growth of Islamic finance, Muslims and non-Muslims alike.

What strikes me as a practitioner about the Forum* – apart from its sheer scale, which would not have been matched only a few years ago – is the place given to practical legal issues. This is an occasion about getting things done – about moving things forward.

We have the IFSB programme over the next two days, at which five surveys commissioned by the Islamic Financial Services Board are being presented.

At the same time, we have the Banking and Financial Law School. I share the enthusiasm of my distinguished colleague Assistant Governor Gopal Sundaram for the course book. Collections of documentation of this kind are indeed valuable. No one has an excuse anymore for not understanding the mechanics of the issuance of a *sukūk*!

My main purpose this morning is to introduce and welcome the five surveys. But to do that, I need to put the legal issues into context.

So first, I will seek to justify what I said a moment ago about the study of legal issues acquiring a new sense of direction. That means saying something about the reform process that is proceeding apace internationally.

Then I will mention a core issue. The varied backgrounds of the delegates gathered here neatly makes the point. We know that Islamic finance is growing quickly, and not just in the Islamic world. But finance and law are intertwined with each other. Modern finance is built around complex legal structures.

So, in the context of transacting business, and of resolving disputes, there will be increasing interaction between existing legal systems on the one hand, and the *Shari'ah* to which the transactions are subject on the other. What relationship should we expect to see develop as a result?

Ladies and gentlemen, no country has played a greater role in the development of contemporary Islamic finance than Malaysia. The far-sighted recognition of the potential for Islamic finance – at a time when few others saw it – means that Malaysia is now well placed to reap the benefits.

But other financial centres are keen to catch up. That is why legal issues are receiving so much attention at this time. There are three aspects of law reform that I want to draw attention to this morning.

- The first are steps that are being taken to place Islamic finance on an equal footing with conventional finance from the legal point of view.
- The second are reforms of the substantive law where such reforms are perceived to be necessary to grow the market.
- And the third is the sometimes neglected, but in fact crucial, subject of documentation.

Let me begin with an example from the UK's annual budget, which was presented last week.

It was announced to Parliament that legislation will be introduced to remove any tax disadvantage that a *sukuk* bond issue may have as compared with a conventional securitisation. The express intention is that *Shari'ah*-compliant products should be treated equally with their conventional counterparts.

Now, I do not claim that this measure was very widely noticed. To be honest, most people would probably have preferred a cut in their income tax! But the fact that a non-Islamic country should take such a step shows a number of things.

Most obviously, it shows a belief in the market, and in the future of the market. But perhaps even more important, it also shows a conviction that Islamic finance belongs in the mainstream. I should add that this same conviction has informed much of the work of the IFSB since its foundation.

The UK is not, of course, in any way unique. Last year, the Swiss Federal Banking Commission awarded a full banking licence to an Islamic private bank. And the presence here of Mr. Thomas Baxter shows the commitment of the Federal Reserve Bank of New York.**

There is no doubt that London is transacting a growing volume of Islamic finance. Doubtless there are various reasons for that. Now, a point that has often been made – but it is worth repeating it this morning – is that there are linkages here between law and the markets. Indeed, the notion of linkages is one of the themes of this forum.

I note in passing that the common law has traditionally favoured innovative finance. There is a view – which I share – that its flexibility is well suited to the particular needs of developing Islamic finance. Be that as it may, there are lessons to be learned for us here in Malaysia, since it also is a member of the common law family.

My second heading concerns the substantive law. Here, there have been important law reforms within the Islamic world itself. A good example is Bahrain's Law No. 23 of 2006 regarding financial trusts. The trust, as we are all aware, has played an important role in facilitating Islamic products in the financial markets, and is rightly the subject of one of the comparative surveys to be presented this week.

But laws do not exist in the abstract. They have to be observed, and at need, they have to be enforced. Law No. 23 of 2006 prompts me to refer to another point. A key issue revolves around the jurisdictional question – that is, where are disputes about these products to be determined? And what law will be applied to them? In the case of Bahrain's trust law, a kind of hybrid solution is adopted. There is to be a Dispute Resolution Committee within the Central Bank itself. It is to consist of judges of the Bahrain Court of Appeal, together with someone experienced in financial transactions. An appeal lies to the Court of Cassation (Supreme Court). The law to be applied consists of the provisions of Law No. 23 itself.

My third heading concerns documentation. The standardisation of documentation is crucial in providing consistency and reducing transaction costs. Of course, precedents are available to market practitioners. But there are mechanisms which can be powerful drivers in that respect, of which there are a number of examples.

The Loan Market Association has produced standard documents covering, in particular, *murābahah* financing, which is being used to facilitate inter-bank lending, allowing financial institutions to manage their Treasury requirements in a *Sharī'ah*-compliant manner.

Last year, the International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association (ISDA) agreed to work together on the thorny topic of a Master Agreement for documenting privately negotiated *Sharī'ah*-compliant derivative transactions. Of course, there are issues of substance regarding derivatives still to be resolved. Some here are involved with this task. But a collaborative venture of this kind seems well suited to achieve the consensus that will be needed to get a market off the ground.

Further, it was announced in January that the International Capital Market Association (ICMA) and the IIFM have agreed to work together to develop standardised contracts and documentation for *sukūk*.

Taking these three headings together, it can be seen that legal issues are being identified, and addressed, and in the process perceived legal risk is rendered more readily manageable.

There are clues here as well as to my second topic, the interrelationship between existing legal systems and the *Sharī'ah* in the context of Islamic finance. Let me now say a little more about that.

It is important to start by making the point that some degree of legal risk is inevitable. The swaps market suffered a reverse in the early nineties when local authority swaps were struck down by the courts as unenforceable. But the market soon recovered. As always, it is a matter of degree of risk, and managing risk.

A crucial provision in all financial documentation is, of course, the choice of law and jurisdiction. According to the Loan Market Association, the governing law and jurisdiction provisions in an Islamic facility are typically the same as for any equivalent conventional facility. In the well-known

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